IT 99-1
Tax Type: INCOME TAX
Issue: Penalty Under 1002(d) – Failure To File/Pay Withholding

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	**No. 95-IT-0000**
	FEIN: 38-0000000
v.	**Tax yr.: 1982 through 1991**
"Bustemup" Insurance Co., Taxpayer	**Charles E. McClellan Administrative Law Judge**

ORDER ON TAXPAYER'S MOTION FOR SUMMARY JUDGMENT AND THE DEPARTMENT'S CROSS MOTION FOR SUMMARY JUDGMENT

"Bustemup" Insurance Co. ("Bustemup") is a wholly owned subsidiary of "Scratchpad" Paper Company ("Scratchpad"). The Department audited "Bustemup" for the tax years 1982 through 1991 [1]in connection with its audit of "Scratchpad". At the conclusion of the audit, the Department issued "Bustemup" a Notice of Deficiency ("NOD") which "Bustemup" protested in a timely fashion.

This matter comes on as the result of a Motion for Summary Judgment filed on July 31, 1998, by "Bustemup". The Department filed a response to "Bustemup"'s motion as well as its cross motion for summary judgment on November 12, 1998. "Bustemup" filed a reply on November 25, 1998.

[1] "Bustemup" files its income tax returns on a calendar year basis.

"Bustemup"'s motion presents three issues. The first issue is whether "Underwrite", a Delaware corporation, wholly owned by "Scratchpad", is required to file a combined Illinois income tax return with "Bustemup". The second issue is whether "Bustemup" has the requisite nexus with Illinois to be subject to Illinois income tax. The third issue is whether the gain on the sale of the "Lowball" Limited stock is business or non-business income. "Lowball" Limited ("Lowball") was incorporated in the Cayman Islands by "Scratchpad" and other investors in 1986 to write excess liability or catastrophic insurance coverage which was prohibitively expensive on the open market as a result of the Union Carbide disaster in Bhopal, India.

Facts

The uncontroverted facts stated in the parties' motions, which comprise the basis for their motions are as follows:

1. "Underwrite" Limited ("Underwrite") is a Delaware corporation, wholly owned by "Scratchpad". (TP Motion p. 1)

2. "Scratchpad" formed "Underwrite" in 1986 to act as a holding company. (*Id.*)

3. "Underwrite" owned all of the issued and outstanding stock of "Lumberjack" Insurance Limited ("Lumberjack"), "File-A-Claim" Reinsurance Limited ("File-A-Claim"), and the taxpayer, "Bustemup". (*Id.*)

4. "Lumberjack" is incorporated, and engages in the insurance business, in Bermuda. (*Id.*)

5. "File-A-Claim" is incorporated in Bermuda and engages in the insurance business in both Bermuda and the Netherlands. (*Id.*)

6. "Underwrite" owned 2.3% of the stock of "Lowball" which was incorporated in the Cayman Islands and was authorized to transact business in both Bermuda and the Cayman Islands. (TP Motion p. 2, Dept. Memo. p. 3[2])

7. "Scratchpad" and other investors formed "Lowball" for the sole purpose of writing excess liability insurance for its investors. (Dept. Memo. p. 3)

8. "Scratchpad" and the other investors created "Lowball" in 1986 because the cost of excess liability or catastrophic insurance coverage was prohibitively expensive on the open market as a result of the Union Carbide disaster in Bhopal, India. (*Id.*)

9. "Scratchpad" transferred the stock it owned in "Lowball" to "Underwrite" in 1986. (*Id.*)

10. "Bustemup" applied for and renewed its Certificate of Authority with the State of Illinois. (*Id.*)

11. "Bustemup" received direct premiums for insurance written on property and risk of loss in Illinois which it reported on its annual statements and the privilege tax return it filed with the Illinois Department of Insurance. (*Id.*, Dept. Exs. No. 2, 3)

12. The only direct insurance written by "Bustemup" was to "Scratchpad" on its property or risk wherever located, including in Illinois. (Dept. Memo p. 3, 4; Dept. Ex. No. 5)

[2] The Department's memorandum in support of its cross-motion for summary judgment and in opposition to taxpayer's motion for summary judgment is referred to herein as "Dept. Memo".

13. "Bustemup" engaged Illinois reinsurance intermediaries, including (some long name, Inc.) of (Someplace), Illinois, to negotiate contracts for reinsurance activities with insurance companies domiciled in Illinois. (Dept. Memo. p. 4)

14. During 1991, "Underwrite" sold its 2.3% interest in "Lowball" for a gain of $13,402,685. (Dept. Memo p. 5; TP Motion p. 2)

15. From its formation in 1986 through 1991, "Underwrite" paid no employees and performed for "Bustemup" no centralized services, such as accounting, personnel, purchasing, advertising, legal or financing. (*Id.*)

16. "Underwrite" did not own any operating assets, such as buildings, equipment, or inventory. (*Id.*)

17. "Scratchpad" transferred all of its control over its insurance subsidiaries to "Underwrite". (Dept. Memo p. 5)

18. "Underwrite"'s board of directors authorized the president of "Bustemup" to enter into a six year lease for the second floor of the "Daily Planet" Building in (Anywhere), Michigan. (*Id.*)

19. The "Daily Planet" lease was worth about $232,000 per year and included a furniture lease for $450,000 per year. (*Id.*)

20. The "Underwrite" Finance Committee shifted $3,000,000 of the equities portion of the "File-A-Claim" portfolio to the fixed income portion of the "File-A-Claim" portfolio. (*Id.*)

21. "Underwrite" authorized "File-A-Claim" to enter into a low risk investment program called “deep-in-the money buy writes”. (Dept. Memo p. 6)

22. "Underwrite"'s finance committee approved the portfolio reports of all three of its subsidiaries. (*Id.*)

23. "Bustemup" and "Underwrite" had been included historically in "Scratchpad"'s consolidated federal income tax return. (TP Motion p. 2)

24. In 1989, while auditing "Scratchpad"'s income tax returns for the years 1985 through 1987, the Department determined that "Bustemup" and "Underwrite" were includable in "Scratchpad"'s unitary group. (*Id.*)

25. Later the Department determined for the years 1985 through 1987 that, under section 1501(a)(27)[3], these corporations (and others) belonged to a group separate from "Scratchpad". (*Id.*)

26. The Department audited "Bustemup"'s tax returns for the years 1977 through 1981 and concluded that "Bustemup" was not required to file Illinois income tax returns for those years, because Schedule T of its annual statements for insurance companies, required by the Illinois Department of Insurance, showed that no direct or reinsurance premiums were written in Illinois. (*Id.*)

27. When the Department audited "Bustemup" for the years 1982 through 1991, it determined that "Bustemup" should have filed Illinois income tax returns. (TP Motion p. 3)

28. On November 28, 1994, the Department issued a Notice of Deficiency ("NOD") to "Bustemup" for the years 1982 through 1991 assessing tax of $558,767 and penalties of $214,782 for a statutory deficiency of $803,549. (*Id.*, Dept. Memo p. 6)

[3] Unless otherwise noted, all statutory references are to 35 ILCS 5/101, *et seq.*, the Illinois Income Tax Act .

29. On January 20, 1995, "Bustemup" filed a protest to the NOD, which it amended on April 29, 1997, adding an argument that "Bustemup" had insufficient activity in Illinois to constitute the degree of nexus to be subject to Illinois income tax. *Id.*

30. By letter dated April 20, 1993, "Bustemup" remitted $60,746 to the Department as payment of the underlying tax deficiency for the years 1982 through 1988. (TP Motion p. 3)

31. By letter dated September 20, 1993, "Bustemup" remitted an additional $382,770 for the underlying tax attributable to tax years 1989 through 1991. (*Id.*)

32. Sometime later, "Bustemup" remitted $69,616 attributable to a computational difference leaving a balance of proposed tax due of $75,677 attributable to "Underwrite"'s sale of the "Lowball" stock. (*Id.*)

33. "Bustemup" did not pay the amount of penalties and interest assessed. (Dept. Memo p. 6)

34. In the letter of September 20, 1993, "Bustemup" stated that it accepted the tax liabilities for 1989 and 1990 as originally calculated in the audit and a recalculated number for 1991. (Dept. Memo p. 7)

Summary Judgment

A motion for summary judgment is proper if the pleadings, depositions, admissions on file, affidavits and exhibits show that there is no genuine issue as to a material fact. The non-moving party's claim of conflicting facts unsupported by affidavits or depositions will not preclude the granting of summary judgment. Schmidt v. Hinshaw, *et al*, 75 Ill. App. 3d 516, 521 (1st Dist. 1979) The standards for granting summary judgment have been described by the Illinois Supreme Court in the following terms:

> "Section 2-1005(c) of the Civil Practice Law [now 735 ILCS 5/2-1005] provides that summary judgment shall be granted if the pleadings, depositions, and admissions on file together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law. Although summary judgment is to be encouraged as an aid in the expeditious disposition of a lawsuit [citation omitted], it is a drastic measure and, therefore, should be allowed only when the right of the moving party is free from doubt [citations omitted]. The court must construe the pleadings, depositions, admissions, exhibits, and affidavits on file strictly against the movant in determining whether a genuine issue of material fact exists. [citation omitted]. Reed v. Bascon, 124 Ill. 2d 386 (1988); Mutual Life Insurance Company of New York v. Washburn, 183 Ill. App. 3d 978 (4th Dist. 1989).

"To survive a motion for summary judgment, the nonmovant must come forward with evidentiary material that establishes a genuine issue of fact." Lassai v. Holy Cross Hospital, 224 Ill. App. 3d 320, 334 (1st Dist. 1991) In this case, neither party has alleged that there is a genuine issue of material fact. Therefore, summary judgment is appropriate.

The Combined Return Issue

The first issue raised by "Bustemup's" motion is whether "Underwrite", being a holding company with no property, payroll or sales, is required to file a combined return with "Bustemup". "Underwrite's" parent corporation, "Scratchpad", apportions its income under section 304(a), which mandates the three factor apportionment formula taking into account the proportion of the taxpayer's sales, property and payroll in Illinois to its sales, property and payroll everywhere. "Underwrite's" subsidiary, "Bustemup", being an insurance company, must apportion its income under section 304(b) which mandates a single factor apportionment formula consisting of the proportion of its premiums written on property or risk in Illinois to its premiums written on property or risk everywhere.

"Bustemup" argues that the statutory definition of "unitary business group" is unclear, so that it has the choice of either including "Underwrite", a holding company, in a combined return with its parent, "Scratchpad", or combining "Underwrite" with its

insurance subsidiaries in a separate group. "Bustemup" argues further that because the statute is unclear, it must be construed strictly against Department and in favor of the taxpayer.

The Department finds no ambiguity in the statute. It argues that since "Underwrite" functions as a holding company of three insurance companies it must be included with them as a separate unitary business group. The Department cites Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 440, 100 S. Ct. 1223 (1980), for the proposition that "a holding company may be in the same line of business as its subsidiary." It argues that "Underwrite"'s activities, namely monitoring, reviewing and approving investment portfolios shows that it was in the same line of business as "Bustemup". "Bustemup" argues that these functions were little more than those required by the Michigan Business Corporation Act.

Mobil Oil Corp., is of little help in this case because it is factually distinguishable. Mobil Oil Corp. was an operating company that owned subsidiary corporations with which it was vertically integrated. It performed holding company functions and it also conducted operations. A "holding company" is "a company that confines its activities to owning stock in, and supervising management of, other companies." Black's Law Dictionary 658 (5th edition, 1979). Thus, Mobil Oil Corp. was not a "holding company" as that term is normally understood. "Underwrite", whose sole function is owning the insurance companies, is a true "holding company", so its situation is factually distinguishable from that involved in Mobil Oil Corp.

In addition, the issue involved in Mobil Oil Corp. was not the same as the issue in this case. Mobil Oil Corp. involved Vermont's attempt to tax dividends received by Mobil

Oil Corp. from its operating subsidiaries. Vermont did not assert a combined income approach to taxation of affiliated corporations, so the question of whether a holding company can or must be combined with its subsidiaries was not involved in that case.

The Department also relies on its instructions to form IL-1120 Schedule UB (1990), which read, in part, as follows:

> A holding company should generally be treated as unitary with one or more subsidiaries only if:
> a. It is unitary in operations with one or more of the subsidiaries (in which event it would be an operating-holding company); or
> b. It holds, directly or indirectly, the capital stock of a subsidiary (or of more than one subsidiary which conduct unitary operations); or
> c. The filing by it of a separate return would distort the business income of the controlled group attributable to Illinois.

The Department states that the statute, 35 ILCS 5/1401, provides that instructions have the force and effect of regulations. The Department is correct in arguing that this set of instructions apply to the "Bustemup" situation. Subparagraph b is particularly applicable. The problem with the Department's argument is that the language of the instruction is not mandatory and it is not the same for all of the years at issue. For example, the instructions for 1988 and 1989 state that "a holding company should be treated as unitary with one or more subsidiaries only if" it meets one of the three conditions set forth in subparagraphs a, b, or c. The instructions for 1990 that "a holding company should **generally** be treated as unitary with one or more subsidiaries if" it meets one of the three conditions set forth in subparagraphs a, b, or c. Because these instructions have changed from year to year without any change in the statute to which they relate, they cannot be controlling in this case.

Both parties rely on the language of section 1501(a)(27) in support of their positions. Section 1501(a)(27), in relevant part, defines the term "unitary business group" as follows:

> The term "unitary business group" means a group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute to each other . . ..Common ownership in the case of corporations is the direct or indirect control or ownership of more than 50% of the outstanding voting stock of the persons carrying on unitary business activity. Unitary business activity can ordinarily be illustrated where the activities of the members are: (1) in the same general line (such as manufacturing, wholesaling, retailing of tangible personal property, insurance, transportation or finance); or (2) are steps in a vertically structured enterprise or process (such as the steps involved in the production of natural resources, which might include exploration, mining, refining, and marketing); and, in either instance, the members are functionally integrated through the exercise of strong centralized management (where, for example, authority over such matters as purchasing, financing, tax compliance, product line, personnel, marketing and capital investment is not left to each member). *In no event, however, will any unitary business group include members which are ordinarily required to apportion business income under different subsections of section 304 except that for tax years ending on or after December 31, 1987,* ***this prohibition*** *shall not apply to a unitary business group composed of one or more taxpayers all of which apportion business income pursuant to subsection (b) of section 304, or all of which apportion business income pursuant to subsection (d) of section 304, and a holding company of such single-factor taxpayers* (see definition of "financial organization" for rule regarding holding companies of financial organizations). If a unitary business group would, but for the preceding sentence, include members that are ordinarily required to apportion business income under different subsections of section 304, then for each subsection of section 304 for which there are two or more members, there shall be a separate unitary business group composed of such members . . .. [emphasis added.]

"Bustemup" finds the italicized portion of section 1501(a)(27), *supra*, to be ambiguous. "Bustemup" argues as follows:

> By its terms, section 1501(a)(27) does not permit including in a combined return corporations that are ordinarily required to apportion income under different subparagraphs of section 304. Section 1501(a)(27) expressly lifts that prohibition, however, in the case of a holding company that ordinarily would be required to apportion income under section 304(a)

> but that, as the parent of insurance or transportation companies, may also apportion income under sections 304(b) or 304(d).
>
> "Scratchpad" apportions its income pursuant to section 304(a). "Bustemup", as an insurance company, apportions its income pursuant to section 304(b). Therefore, "Scratchpad" and "Bustemup" clearly cannot be part of the same section 1501(a)(27) unitary group. What is not clear is whether "Underwrite", the holding company/parent of "Bustemup" and certain "Scratchpad" subsidiaries, must apportion its income and be part of the unitary group with "Bustemup" or with "Scratchpad". Neither the statute nor the regulations appear to provide guidance on this question.

"Bustemup" goes on to state that section 1501(a)(27), in lifting the prohibition against combining a three factor (section 304(a)) holding company with its one factor (section 304(b)) subsidiaries, was not intended to prohibit combination of the holding company with its own three factor (section 304(a)) parent. "Bustemup" does not explain how it arrived at this conclusion regarding the intended statutory construction nor does it cite any relevant authority.

Taxing statutes are to be strictly construed. Van's Material Co. v. Dept. of Revenue, 131 Ill. 2d 196, 202 (1989). Their language cannot be extended or enlarged by implication beyond its clear meaning. *Id.* In cases of doubt they are constructed most strongly against the government and in favor of the taxpayer. *Id.* The primary rule in construing a statute is to ascertain and give effect to the intention of the legislature and that inquiry must begin with the language of the statute. *Id.* Legislative history and floor debates may be helpful. *Id.* However, the language of a statute generally provides the best evidence of the legislature's intent. Board of Education of Rockford School District No. 205 v. Illinois Educational Labor Relations Board, 165 Ill. 2d 80, 87 (1995). Where the statutory language is clear and unambiguous, the plain and ordinary meaning of the words will be given effect without resorting to extrinsic aids for construction. *Id.*

The relevant language of section 1501(a)(27) is clear and unambiguous. It begins by providing, “In no event, however, will any unitary business group include members which are ordinarily required to apportion business income under different subsections of section 304 . . ..”This clause, by itself, would require "Underwrite", a 100% owned subsidiary of "Scratchpad", to be combined with "Scratchpad" as part of "Scratchpad’s" unitary group because it is not an insurance company (section 304(b)), a financial organization (section 304(c)), or a transportation company (section 304(d)), and the three insurance subsidiaries, "Bustemup", "File-A-Claim" and "Lumberjack", would be required to file separate tax returns.

Section 1501(a)(27) addresses this situation in the next clause and sentence which provides, in pertinent part, that:

> for tax years ending on or after December 31, 1987, this prohibition shall not apply to **a unitary business group** composed of one or more taxpayers all of which apportion business income pursuant to subsection (b) of section 304, . . .**and a holding company of such single-factor taxpayers** (see definition of ‘financial organization’ for rule regarding holding companies of financial organizations). If a unitary business group would, but for the preceding sentence, include members that are ordinarily required to apportion business income under different subsections of section 304, then for each subsection of section 304 for which there are two or more members there shall be a separate unitary business group composed of such members.

This language clearly mandates that a group of taxpayers required to apportion their business income pursuant to section 304(b) **and** their holding company are not subject to this prohibition and are to be considered a separate unitary business group. Thus, "Underwrite" and its subsidiaries must be considered a separate unitary business group.

"Bustemup" argues that the prohibition in section 1501(a)(27) “was not intended to prohibit the otherwise required combination of the section 304(a) holding company with its

own 304(a) parent." "Bustemup" cites no authority for this proposition, however. "Bustemup" argues further that "Underwrite" is not required to file a combined return with "Bustemup". These arguments are thwarted by the plain language of section 1501(a)(27).

Statutes are to be construed to give them reasonable meaning and in the best way to prevent absurdity. Antunnes v. Sookhakitch, 146 Ill. 2d 477 (1992) The cardinal rule in statutory construction is to give effect to what the legislature intended. Gay v. Dunlap, 279 Ill. App. 3d 140 (4th Dist. 1996) The best indication of legislative intent is the language of the statute. Hansen v. Caring Professionals, Inc., 286 Ill. App. 3d 797 (1st Dist. 1997) "Bustemup's" arguments ignore the language quoted above which mandates that a holding company of one factor corporations be combined in a separate unitary business group with those corporations.

"Bustemup" has posited no logical reason why the legislature would allow a holding company parent of one factor companies to be combined with its three factor parent and leave the one factor subsidiaries to file separate returns. Furthermore, there is no reason to conclude that the legislature would allow taxpayers to choose whether to combine the holding company with its parent or with its subsidiaries. There is no language in the statute providing for such an election. Given the clear language of the statute, a construction as "Bustemup" urges would lead to an absurd result.

Applying the clear language of section 1501(a)(27) to the facts of this case leads to the inescapable conclusion that "Underwrite" must be combined with "Bustemup", "Lumberjack" and "File-A-Claim" as a separate unitary business group.

The Nexus Issue

The second issue is whether "Bustemup" has the requisite constitutional nexus with Illinois. The Department argues that nexus is a moot issue for two reasons. First, the Department argues that because "Bustemup" voluntarily paid most of the proposed deficiency, withholding only an amount equal to the proposed assessment related to the gain realized on the sale of the "Lowball" stock and the penalties assessed[4], it thereby accepted the Department's interpretation that it had substantial nexus in Illinois. Second, the Department argues that the nexus issue is moot because "Bustemup" is barred from filing a refund claim by the statute of limitations.

The Department has cited no cases to support its position that partial payment of a proposed liability is an acceptance of the validity of the entire proposed assessment. The cases cited by the Department are either distinguishable on the facts or law involved. With regard to the statute of limitations argument, "Bustemup" has not paid any amounts that are involved in this matter, so there is no statute of limitations issue.

"Bustemup" argues that because it had no property or employees in Illinois there is insufficient contact to allow Illinois to constitutionally tax the gain it realized on the sale of its "Underwrite" stock. "Bustemup" also relies on discovery deposition testimony of the Department's auditor in which he stated that he never made an attempt to determine if "Bustemup" had any property or employees in Illinois and that nexus was not an issue and he did not think that the word nexus would apply to an insurance company.

The auditor's testimony relied on by "Bustemup" indicates a lack of understanding of the nexus issue. The nexus issue is a legal issue which calls for a legal interpretation.

[4] The penalties were abated by order entered on June 22, 1998, on a motion for partial summary judgment filed by "Bustemup".

Therefore, the auditor's thoughts on the legal issue are not relevant. Furthermore, the Department is not bound by mistakes or misinformation given to taxpayers by its employees. Austin Liquor Mart, Inc. v. Dept. of Revenue, 51 Ill. 2d 1 (1972), Brown's Furniture, Inc. v. Wagner, 171 Ill. 2d 410, (1996, (*cert. den.*, 117 S. Ct. 175 (1996). The question of nexus does not depend on the auditor's understanding of the nexus concept, or the lack thereof. Rather, it depends on the facts shown by the evidence in the record.

"Bustemup" also objects to the proposed deficiency on constitutional grounds. "Bustemup" correctly states that "contemporary 'dormant commerce clause' analysis prohibits state taxation of interstate commerce that is unduly restrictive or discriminatory," citing Brown's *supra* at 410, 420. "Bustemup" cites Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977) for the rule that in order to withstand scrutiny under the commerce clause of the U.S. Constitution, a person or entity must have activity within the state that constitutes "substantial nexus" with the taxing state.

The most recent U.S. Supreme Court case dealing with the substantial nexus issue under the commerce clause is a sales and use tax case, Quill Corp. v. North Dakota, 504 U.S. 298 (1992). The facts in that case are that Quill had no physical presence within North Dakota. It solicited sales of office equipment and supplies in North Dakota through catalogs and flyers, advertisements in national periodicals and telephone calls. *Id*. at 302. It shipped all of its products to its customers by common carrier or mail. *Id*. It had no employees or property in North Dakota other than some software disks containing inventory and pricing information. *Id*. In that case, the Court held that there was insufficient contact within the state to establish substantial nexus. *Id*. at 315.

Neither "Bustemup" nor the Department cite any case law in Illinois or any other state addressing the nexus elements pertaining to an insurance company, and I have been unable to find any. Accordingly, this seems to be a case of first impression.

The facts regarding "Bustemup's" activities in relation to Illinois differ significantly from Quill's lack of physical presence in North Dakota. The contacts "Bustemup" had with Illinois during the years at issues were several. First, as required by statute for regulatory purposes, "Bustemup" registered with the Illinois Department of Insurance so that it could insure and reinsure property and risks in Illinois. (See 215 ILCS 5/109) In addition, "Bustemup" received premium income for insuring property and risks in Illinois as reported on its annual statements filed with the Illinois Department of Insurance and it paid privilege tax to Illinois. Finally, "Bustemup" engaged reinsurance intermediaries in Illinois as independent contractors to negotiate its contracts for reinsurance activities with insurance companies domiciled in Illinois. I find that these factors are enough to conclude that "Bustemup" has substantial nexus with Illinois.

The Business/Non-business Income Issue

The third issue is whether the gain on the sale of the "Lowball" stock by "Underwrite" is business or non-business income. "Bustemup" argues that the gain on the sale of "Lowball" stock is not taxable by Illinois because it is non-business income allocable to the state of domicile and neither "Underwrite" nor "Bustemup" are domiciled in Illinois. The Department argues that the gain is business income subject to apportionment.

Section 1501(a)(13) defines "non-business income as any income other than business income. Section 1501(a)(1) defines "business income" as follows:

> The term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business, net of the deductions allocable thereto, and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. Such term does not include compensation or the deductions allocable thereto.

Section 1501(a)(1) sets forth two tests to determine if income is business income, the "transactional test" and the "functional test". Income is classified as business income under the transactional test "if it is 'attributable to a type of business transaction in which taxpayer regularly engages.'" Texaco-Cities Service Pipeline Co. v. McGraw, 182 Ill. 2d 262, 269 (1998), quoting National Realty & Investment Co. v. Dept. of Revenue, 144 Ill App. 3d 541 (1986); Kroger v. Illinois, 284 Ill. App. 3d 473 (1st Dist. 1996). Whether the gain at issue in this case is business income under the transactional test is not at issue.

Under the functional test, gains from the disposition of assets are considered business income if the assets disposed of were used by the taxpayer in the regular course of its business. *Id.* Both parties cite Texaco-Cities, and Kroger to support their arguments. A brief review of the factual situations and holdings in these two cases is helpful in arriving at a resolution of the issue in this case.

Kroger, a publicly held corporation, operated food and convenience stores within and without Illinois during the years at issue. Kroger, 284 Ill. App. 3d at 476. Kroger also owned four unitary subsidiaries which were engaged in the retail drug store business within and without Illinois. *Id*. During the years at issue Kroger began a restructuring program in which it sold or closed all of its separately established drug stores and its unprofitable food stores. *Id*. at 477. As part of the restructuring, Kroger sold tangible and intangible assets including leasehold interests. *Id*. Kroger reported the gains from the sale

of the leasehold interests as non-business income. *Id*. The Department proposed to reclassify those gains as business income. *Id*. In reaching its conclusion that the gains were business income under the functional test, the court stated that the functional test "refers to the conditions of ownership of property by the taxpayer; it is not limited to a taxpayer's trade or business, but includes 'operations' of the taxpayer's business, such as the sale of leasehold interests." *Id*. at 479. Because the leaseholds were for Kroger's store sites and were used in its regular trade or business, the court held that the gains from their disposition was business income. *Id*. at 482.

Texaco-Cities, a Delaware corporation with its principal offices in Houston, Texas, is in the business of transporting crude oil and other petroleum products by pipeline. Texaco-Cities, 182 Ill. 2d at 265. Texaco-Cities owned and operated pipelines which ran through several states including Illinois. *Id*. During 1983, Texaco Cities sold major components of its pipeline assets and associated real estate including its pipeline assets in Illinois. *Id*. Texaco-Cities realized a gain on the sale which it reported as non-business income on its Illinois income tax return. *Id*. The Department reclassified the gain as business income. *Id*. In analyzing the statute, the court explained that the second clause of section 1501 providing for the functional test enlarges on the definition in the first clause to include income from property, as long as its "acquisition, management and disposition" constitute "integral parts of the taxpayer's regular trade or business operations." Texaco-Cities, 182 Ill. 2d at 270. The court upheld the Department's reclassification because the property sold was used in Texaco-Cities regular course of business. *Id*. at 273, 274.

With regard to the functional test, the Department argues that the investment in "Lowball" stock constituted an operational function to "Underwrite" and the "Bustemup"

unitary business group by enabling the group to purchase excess liability insurance for "Scratchpad", their parent corporation, that was not otherwise available. "Bustemup" argues that because "Underwrite" never engaged in a business other than that of a holding company and because "Underwrite" was not a holding company with respect to its 2.3% interest in "Lowball", as a matter of law, the gain on the sale of the "Lowball" stock was non-business income.

"Bustemup's" arguments must fail because they ignore the corporate structure involved in this case and the language of section 1501(a)(27). "Underwrite" is a wholly owned subsidiary of "Scratchpad". "Bustemup" is a wholly owned subsidiary of "Underwrite". "Underwrite", "Bustemup", "File-A-Claim" and "Lumberjack" constitute a separate unitary group under the plain language of section 1501(a)(27). The sole purpose of forming "Underwrite" was to operate as a holding company for "Scratchpad's" insurance subsidiaries which were "Bustemup", "File-A-Claim" and "Lumberjack". All four of these corporations functioned to provide insurance or reinsurance for "Scratchpad's" operations. All of these corporations would be part of "Scratchpad's" unitary business group under the definition of section 1501(a)(27) were it not for the requirement that the insurance subsidiaries and their holding company apportion income under a single factor apportionment formula rather than the three factor formula used by "Scratchpad". "Scratchpad" caused "Underwrite" to invest in "Lowball" after the Bhopal incident when it could no longer obtain elsewhere the excess liability or catastrophic insurance coverage it needed for its various operations. By obtaining for "Scratchpad" the excess liability insurance it required, the investment in "Lowball" served an integral function in the operations of "Underwrite" and "Scratchpad". The "Lowball" investment

did not produce income until it was sold. However, it did provide insurance to fill out the insurance portfolio of "Underwrite" held to protect "Scratchpad", "Underwrite's" parent, from catastrophic losses. In this way it served an integral part of "Underwrite's" business of owning, controlling and managing the risks its parent, "Scratchpad", incurred in its regular business. Thus, it was an integral part of "Underwrite's" business. Therefore, the gain on the sale of the "Lowball" stock is business income under the functional test.

"Bustemup" cites a number of U. S. Supreme Court decisions to bolster its argument that the gain on the sale of "Underwrite" stock is non-business income. "Bustemup" cites ASARCO Inc. v. Idaho Tax Comm., 458 U.S. 307 (1982) and F. W. Woolworth Co. v. Taxation and Revenue Dept., 458 U.S. 354 (1982) to support its argument that because "Underwrite" did not control "Lowball", the gain on the sale of "Lowball's" stock could not be business income. In ASARCO and Woolworth the Supreme Court held that dividend and capital gain income derived from investments in non-unitary affiliates was not apportionable business income to the parent because the affiliates were discrete enterprises not controlled by the parent corporation.

In the instant case, the gain on the sale of the "Lowball" stock was realized by "Underwrite", a wholly owned and controlled subsidiary of "Scratchpad", hardly a discrete enterprise. Therefore, these cases are factually distinguishable.

"Bustemup" also cites Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768 (1992). However, the decision in that case does not support its position. In Allied Signal the Supreme Court held that the gain realized on the sale of a 20.6% equity interest that the taxpayer owned in ASARCO, Inc., was not business income and could not be apportioned by New Jersey. *Id*. at 790. The reason was that to be apportionable, the

investment must be operational rather than an investment. *Id*. at 787. In the Allied Signal case, Allied Signal's investment in ASARCO served an investment function rather than an operational function. *Id*. In this case, the investment in "Lowball" served an operational function by enabling "Bustemup" to obtain insurance it could not obtain elsewhere insuring catastrophic risks for "Scratchpad".

Finally, in support of its position "Bustemup" cites a recommendation for disposition, IT-98-9, written by Linda K. Brongel, an administrative law judge, which can be found at www.revenue.state.il.us/lawsnleg/hearings/it. That recommendation is inapposite, however because the facts show that the investment which gave rise to the gain at issue had no operational relationship to the taxpayer's business. In this case, the "Lowball" stock did have an operational relationship to the taxpayer's business.

WHEREFORE, "Bustemup"'s motion for summary judgment is denied, the Department's cross motion for summary judgment is granted; and

IT IS ORDERED, that the Notice of Deficiency be revised to eliminate the penalties that were previously abated by order, and, as so adjusted, the Notice of Deficiency should be made final.

June 24, 1999 **ENTER:**

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Administrative Law Judge